3-23-99

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-441-99
JRCattell

date:

to: Chief, Examination Division, Pennsylvania District
CEP Branch
Attn: Kathleen Follis

from: District Counsel, Pennsylvania District, Philadelphia

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subject: [redacted]

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This memo is in response to your request for advice with respect to the debt-equity issue arising from a loan of $[redacted]. from [redacted] to [redacted] made in [redacted]. We have had several meetings with respect to this issue, and some of the information contained herein will reiterate suggestions and questions discussed at those meetings. We believe this issue deserves further attention and factual development, [redacted (b)(5)(DP), (b)(7)a]. Some items have already been requested in Information Document Requests, and some of that information has been produced by taxpayer. We will make additional suggestions about information

and documents which should be requested.

The facts as we understand them are as follows:

[redacted] (parent) owns [redacted]% of [redacted] ([redacted]). [redacted] and the [redacted] ([redacted]), an unrelated taxpayer, became [redacted]% and [redacted]% owners of stock in [redacted] (an LLC) in [redacted] of [redacted], with cash contributions totaling about $[redacted]. Under the LLC agreement, [redacted] is guaranteed an annual return on their investment, which can be exercised by receiving [redacted] stock after several years.

[redacted] then contributed $[redacted] and allegedly "loaned" and additional $[redacted] to become [redacted]% owner of [redacted] ([redacted]). Finally, [redacted] made a capital contribution of about $[redacted] to [redacted] ([redacted]). [redacted] borrowed an additional $[redacted] through a Credit Agreement (also called an Acquisition Facility) with several banks.

This $[redacted] ($[redacted] plus $[redacted] capital contribution) was used to purchase the [redacted] and alternate access operations of [redacted] plus the stock of [redacted] from [redacted], a [redacted]. (called the [redacted]). The [redacted] $[redacted] debt was then distributed via the [redacted] as a change in retained earnings, listed as a cash distribution, and recorded as an increase to long term liabilities among [redacted] state [redacted] subsidiary companies of [redacted] (apparently to take advantage of the interest deduction for state income tax purposes). These companies have income and can use the deduction.

While the interest due on the $[redacted] loan is paid to third parties, the interest on the $[redacted] loan from [redacted] to [redacted] is only accrued. [redacted] has income, and takes an interest deduction which it can use. Since [redacted] is an exempt plan, (which we do not have under audit), we believe they pay no tax on the accrued interest. [redacted] already has net operating losses, so any potential additional income would have minimal tax impact for them. The tax impact results from the deduction now reported by [redacted]. The issue is whether this is in substance a loan or is really a capital contribution.

The issue of debt versus equity is a factually intensive one which must be developed. In the case of Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972), Aff'g T.C. Memo 1970-182, both courts held that the notes in question were capital contributions, and not loans. The Tax Court looked at

the form of the notes given, the adequacy of initial capital, security or guarantees given, and subordination of the "note". The Appeals Court again cited the fifth circuit case of Montclair, Inc. v. C.I.R., 318 F.2d 38 (5th Cir. 1963) at p. 40 where that Court outlined 11 facts which bear most strongly on the determination of the label to be applied to the transaction. They include the source of the payments, the right to enforce payment, participation in management, identity of interest between creditor and stockholder, the names on the certificates, and a status equal to or inferior to other creditors.

The more recent case of Laidlaw Transportation, Inc. and subs. v. Commissioner, T.C. Memo 1998-232 also held that the advances were equity and no interest could be deducted. LTL had financed its expansion in the United States by lending money and contributing capital to its subsidiaries in the United States. The Tax Court held that these loans were from a related corporation. Judge Colvin began his analysis by referring to several cases which clearly state that a payment for which a taxpayer seeks a deduction must have economic substance. He then went on to cite many of the criteria already outlined, to show that in substance these were related entities with interlocking directorates, indicating no arm's length negotiation for the loans. In addition, the lack of a reasonable expectation of repayment, and the circular flow of funds hurt petitioner's case in Laidlaw.

(b)(5)(AC), (b)(5)(DP), (b)(7)a [redacted]

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[redacted]

(b)(5)(AC), (b)(5)(DP), (b)(7)a

[redacted]

(b)(5)(AC), (b)(5)(DP), (b)(7)a

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(b)(5)(AC), (b)(5)(DP), (b)(7)a

[redacted]

(b)(5)(AC), (b)(5)(DP), (b)(7)a [redacted]

(b)(5)(AC), (b)(5)(DP), (b)(7)a [redacted]

(b)(5)(AC), (b)(5)(DP), (b)(7)a [redacted]

If you have any questions, please contact Joellyn R. Cattell of our office. She can be reached at 215-597-3442.